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Timber and taxation

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Timber and

The tax-wise owner of timber can realize capital gain from sales, exchanges or utilization of his timber. This is permitted under sections 631 and 1231 of the 1954 Code (and its predecessor provisions under the 1939 Code). This article will discuss some of the tax planning problems which may be encountered in obtaining the advantages of section 631. Space limitations do not permit as full a discussion as may be desirable, but a list of additional references is appended.

Need for Legislation

Before discussing the present rules of section 631, some historical perspective should be helpful. Prior to 1944, a mill operator could obtain a capital gain benefit only by an outright sale of timber which was a capital asset or an asset used in his trade or business. Also an investor could obtain a capital gain benefit only by an outright sale of timber. Neither could obtain a capital gain benefit if he was a dealer. Since private sales of timber usually involve a considerable amount of money, an outright sale was difficult to conclude.

To overcome this problem timber was sold on a pay-as-you-cut basis. That is, a cutting contract was executed granting timber cutting rights for a unit price per thousand board feet (MBF). This procedure raised the question of whether the consideration was for the sale of tim-

ber or a royalty. The Treasury related timber (a natural resource) to mineral deposits and held, as in the case of mineral leases, that the payment represented a royalty and as such was ordinary income despite the fact that the timber was a capital asset in the hands of the taxpayer.

This situation depressed the wood products industry because investors wanted to make only outright sales of timber and small operators could not meet the terms. Mill operators with their own stands of timber were reluctant to cut and create ordinary income out of the appreciation accruing during a long holding period. To a certain extent this resulted in mill operators selling blocks of timber back and forth to attain a tax saving even though such sales would result in an economic loss because of the location of the exchanged timber.

Congress concluded that the law discriminated against taxpayers who disposed of timber by cutting it as opposed to those who sold it outright. In order to eliminate this discrimination, the Senate added to the Revenue Act of 1943 an election which permitted the taxpayer who for more than 6 months before the beginning of the year had owned timber or had a contract to cut timber to treat

the amounts to file a declaration later. In such filing is as follows: June 15, if the April 1 and before June 2; September 15, if the change occurs after June 1 and before September 15, 1964, if the change occurs after June 1 and before September 15, 1964. The estimated tax may be paid on the remaining payment dates.

If by January 31, 1964, you file your tax return and pay in full the balance on or before January 15, 1964, you may require amended declaration which would be due January 15, 1964; or (c) pay the estimated tax.

8. Amended declaration.—If, after a declaration, you find that your income has substantially increased or decreased, you may file an amended declaration on or before June 15, 1963, September 15, 1964. For this purpose, you may check on back of the bill if one is mailed to you on tax payments. If you do not receive Form 1040-ES (Amended) from the Service office.

Any amended declaration should be filed with the District Director with whom the original declaration was filed even if you move to another district whether or not you expect to file your tax return for 1963 in that district.

9. Additional charge for failure to file a declaration.—An additional charge imposed by law for underpayment of estimated tax except in certain situations does not apply if each installment (a) is at least 70 percent (66 2/3 percent) of the amount due, (b) it would have been paid if based on the year, or (c) is based on a tax credit for income for last year and this year's income. For additional exceptions see Form 2210.

10. Your 1962 income tax.—The line 1(a), Form 1040-ES, is an amount line 12, less the total of any amounts on lines 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 31, 32, 33, 34, 35, 36, 37, 38, 39, 40, 41, 42, 43, 44, 45, 46, 47, 48, 49, 50, 51, 52, 53, 54, 55, 56, 57, 58, 59, 60, 61, 62, 63, 64, 65, 66, 67, 68, 69, 70, 71, 72, 73, 74, 75, 76, 77, 78, 79, 80, 81, 82, 83, 84, 85, 86, 87, 88, 89, 90, 91, 92, 93, 94, 95, 96, 97, 98, 99, 100.

11. How to estimate your tax.—If you made a 1962 return on Form 1040, income, exemptions, and deductions the same, enter on line 1(b) of your amount shown on line 1(a). If you have not made a 1962 return, use Form 10 with related instructions, to assist you in estimating your tax for 1963.

If your income (line 9, page 1, Form 1040-ES) is less than \$5,000, to find your tax use the tax table in the instructions and the dividends received credit if applicable.

You may include estimated tax on your declaration of estimated tax.

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the cutting of timber as a sale or exchange. A disposal of timber, held more than 6 months, with a retained economic interest would be treated as a sale of property used in the taxpayer's trade or business. Timber which qualified under these amendments would be considered property used in a taxpayer's trade or business. The effect of these amendments was to provide capital gain treatment for the sale of timber whether outright or on a cutting basis.

In 1944 Congress reached agreement on this proposal for the taxation of timber and what would be section 117(k) of the 1939 Code went to the President. In vetoing the bill, President Roosevelt stated: "As a grower and seller of timber, I think that timber should be treated as a crop and, therefore, as income when it is sold. This would encourage reforestation." In successfully urging overriding of the veto, Senator Barkley stated, after noting that the President sold Christmas trees: "... to compare those little pine bushes with a sturdy oak, gum, pop-

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lar or spruce, which requires a generation of care and nurturing to produce in the forest, and from which no annual income is derived until finally it is sold, is like comparing a cricket to a stallion."

Section 117(k) was re-enacted in the 1954 Code as Section 631. One of the changes made in the section was to define timber as including "evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes."

Cutting of Timber

Section 631 covers two situations — the cutting of timber and the disposal of timber with a retained economic interest.¹ Section 631(a) allows the mill operator to elect

¹ Section 631 has no effect on the applicability of the regular capital gain and loss provisions. Thus, sales or exchanges of an interest in timber, not qualifying under section 631(b), but held as an investment which qualifies as a capital asset, will result in a capital gain or loss, long or short term, depending on the holding period.



on his return to treat the cutting of his timber as a sale or exchange. The timber which is so treated is considered property used in the taxpayer's trade or business. Under section 1231 the net gain on sales and exchanges of property used in a trade or business is taxed as a capital gain and a net loss is deductible as an ordinary loss. Therefore, if timber gains or losses and other section 1231 gains or losses result in a gain, the gain is a capital gain. If they result in a loss, the loss is an ordinary deduction. The cyclical nature of the wood products industry makes the tie-in with section 1231 extremely important because of the limitation on capital loss deductions.

Timber cut during the tax year must be held 6 months prior to the beginning of the year in order to qualify under section 631(a). If the election is made, all the timber cut during the taxable year is presumed to have been sold as of the first day of the year. In order to determine the section 631(a) gain, it is necessary to determine fair market value as of the first day of the taxable year and to compare this with the adjusted basis for depletion of the timber cut during the year.

The fair market value of timber cut during the year becomes the cost of the timber for all purposes. Thus, it is necessary to redetermine inventory cost for tax purposes, but this should not exceed market if the cost or market method was elected. When the end product which was the subject of a section 631(a) election is sold, the gain or loss realized is ordinary income or loss.

Inventory cost adjustments are usually made on a MBF basis. Lumber and plywood footages are converted back to log footages based on operating conversion results and the ending inventory is presumed to contain a pro rata portion of section 631(a) timber and timber not qualifying under the section. This determination may be made on a company wide basis or on a plant basis so long as the method is consistent.

Information for the Tax Return

In the preparation of a tax return involving section 631(a), two additional schedules are generally provided. The first presents the excess of the fair market value of the timber cut over the cost depletion and supports the gain reported on Schedule D. The second presents the required adjustments to the beginning and ending inventories and supports the Schedule M adjustment. The section 631 changes to be made to a conventional tax return can best be understood by journal entry presentation as follows:

(1) Depletion	\$200,000	
Capital gain (Sec. 1231)		\$200,000
To record additional depletion and gain under section 631(a) as follows:		
Fair market value of timber as of January 1, 1962	\$500,000	
Cost depletion of timber cut	300,000	
Additional depletion	<u>\$200,000</u>	
(2) Cost of sales (beginning inventory)	12,000	
Surplus		12,000
To record prior year's section 631(a) gain in the beginning inventory.		
(3) Surplus	15,000	
Cost of sales (ending inventory)		15,000
To record current year's section 631(a) gain remaining in the ending inventory.		

Illustration of Section 631(a)

To show the importance of section 631 to a mill operator, three examples are presented below for a corporate taxpayer and an individual taxpayer assuming no other section 1231 gains or losses and that all timber cut was sold. In these examples the difference between the fair market value at the beginning of the year of timber cut during the year and the cost of such timber (section 631(a) gain or loss) is treated as realized in a sale or exchange of property used in a trade or business. Under section 1231, the gain is treated as a capital gain and the loss is deductible as an ordinary deduction.

As can be noted from the above examples, there is a greater advantage to noncorporate taxpayers because the additional depletion lowers the tax bracket with the added advantage of a 50% capital gains deduction. This does not necessarily mean that a mill operator should not incorporate, but does point up the difference in tax rates. The saving to a corporation of 27% (52% — 25%) is well worth the effort. To illustrate this point, Treasury Officials appearing before the House Ways and Means Committee reported the 1961 tax rate of Weyerhaeuser as 27%, Georgia Pacific 28% and U.S. Plywood 30%.

	<u>A</u>	<u>B</u>	<u>C</u>
<i>Corporate taxpayer</i>			
Taxable income	\$200,000	\$200,000	\$200,000
Depletion adjustment under 631(a)	100,000	(100,000)	400,000
Balance before 631(a) gain or loss	\$100,000	\$300,000	\$(200,000)
Section 1231 loss (ordinary deduction)		100,000	
Subject to normal and surtax	\$100,000	\$200,000	\$(200,000)
Subject to alternative capital gains tax	100,000	—	400,000
Taxable income	\$200,000	\$200,000	\$200,000
Income tax without 631(a)	\$ 98,500	\$ 98,500	\$ 98,500
Income tax with 631(a)	71,500	98,500	98,500(2)
<i>Individual taxpayer (3)</i>			
Subject to normal and surtax (as above)	\$100,000	\$200,000	\$(200,000)
50% of capital gains	50,000	—	200,000
Taxable income	\$150,000	\$200,000	Nil
Income tax without 631(a)	\$156,820	\$156,820	\$156,820
Income tax with 631(a)	92,320	156,820	Nil

(2) Alternative tax not used since it is more than normal and surtax.

(3) To simplify the problem, it is assumed that the taxpayer has income from other sources equal to his other deductions, including exemptions.

Needless to say, the elimination of taxable income in example C for a non-corporate taxpayer, will be examined closely by the Treasury Department.

Two important conclusions can be drawn from the examples: first, there is everything to be gained and practically nothing to be lost under section 631(a) and, second, tax planning will reap benefits.

Planning for an Election Under Section 631

The possible detriment of section 631(a) involves other section 1231 gains in that the capital gain benefit will be lost if 631(a) losses offset the other 1231 gains. Since this rarely occurs in any material amount and can be mitigated by planning, it can safely be stated that the election of section 631(a) will result in a tax saving in the long-run and should be adopted by every mill operator. Some tax advisors have attributed another detriment to 631(a), that of accelerating income. If the timber is cut and on hand at year end, thereby requiring an increase in the year end inventory valuation, income is created prematurely. This is a factor, especially in the first year under the election when there is no corresponding adjustment to the beginning inventory, but is a limiting factor only and does not overcome the advantage of the election.

The tax planning is very basic: maximize 631(a) gains and maximize 631(a) losses so as to avoid having 631(a) gains offset 631(a) losses in any taxable period. Concentrate the cut of high cost timber during poor economic years since the 631(a) loss is an ordinary deduction. Concentrate the cut of low cost timber during good economic years so that full benefit can be obtained from the resulting 631(a) capital gain but endeavor to avoid a situation where the alternative tax on the 631(a) gain exceeds the ordinary tax on the taxable income. The planning of a loss through cutting high cost timber must take into consideration the adjustment provisions pertaining to operating loss carrybacks and carryovers in order to assure full benefit from the loss.

It should be noted that, under the regulations, timber is not considered cut when it is actually cut. It is considered cut when the quantity of timber felled is first definitely determined in the ordinary course of business.

Acquisitions of timber should not be grouped into one block and one depletion rate, since this destroys all possibility for a mill operator to plan for minimal income taxes. The quantity of timber in a tract is normally determined by a professional cruiser at the time the timber is purchased. The depletion rate is determined by dividing

the MBF into the purchase cost less an apportionment to land. The depletion rate can be by specie (spruce, fir, hemlock) or an over-all rate. The selection of the method depends upon the quantity of minor specie in the tract and the contemplated method of logging the tract. Generally, a separate rate for each specie facilitates production planning as well as planning section 631(a) gains.

Method of Election

The election to use the provisions of section 631(a) is made in the return for the taxable year to which the election is to apply. The form of the election is simply to make the computations to comply with the provisions of the section. The election applies to all timber the taxpayer owns or has a contract right to cut, which is held more than six months prior to the beginning of the taxable year in which the timber is cut. The cut timber (logs) must be used in the taxpayer's trade or business which can include the sale of the logs. The election is binding to subsequent years unless permission is obtained to make the change.

The fair market value of the timber cut during the year is determined on the first day of the taxable year, and is defined as the sale price between a willing seller and a willing buyer, assuming a sale on the particular day. This determination is subject to all the problems of establishing fair market value for other assets and, in addition, is subject to a determination of the cost incurred in converting the timber to logs and transportation to market. The best method of establishing timber fair market values is to use reported government sales in areas where these sales are made. Government agencies are required to appraise timber to be sold. This appraisal takes the form of determining the value of the end product and all costs incurred, going back to the standing tree. The actual government sale, together with the appraisal costs, can be used by the taxpayer, for comparison, in determining the fair market value of his own timber.

Disposal of Timber

The dealer, investor and operator can benefit from the provisions of Section 631(b) which governs sales of timber where the seller retains an economic interest in the timber. The timber is considered to be property used in the trade or business, whether the taxpayer has a trade or business or not, and is, therefore, subject to the provisions of section 1231.

If an economic interest is not retained then the transaction does not come under section 631(b) and the pro-

tection to a dealer is lost. The timber may otherwise qualify as a section 1231 asset or as a capital asset depending upon the circumstances.

The taxpayer selling timber must forego the receipt of a fixed total sum for a block of timber and accept instead a sale of the timber on a unit basis in order to qualify under section 631(b). The consideration under the contract must be determined on a unit basis, i.e., the amount of timber cut, rather than a total basis. An economic interest is evidenced by the fact that the taxpayer looks to a severance of the timber for a return of his investment.

Holding Period

There is no election to come under 631(b); if you meet the requirements of the subsection, its application is automatic. In order to qualify, the timber must be held for more than six months prior to disposal. (Not six months before the beginning of the taxable year, as under subsection (a)). The 1954 Code added a definition of disposal. Regardless of the contract date, the disposal date is deemed to be the date the timber is cut. It is, therefore, possible for a taxpayer to purchase standing timber one day and sell it under a contract with a retained economic interest the same day, and all timber cut under the contract more than six months after the purchase date can qualify for capital gains treatment under section 1231. (As in the case of subsection (a) the date timber is cut means the date when in the ordinary course of business the quantity of timber felled is first definitely determined).

Advances and Minimum Payments

Cutting contracts granting to the purchaser the right to cut all or a particular specie in a specified stand of timber and requiring payment on the basis of a fixed amount per unit generally will qualify. This does not mean that the seller cannot receive advance or periodic minimum payments under the contract, but these payments must be applied against units of timber actually cut under the contract.

Providing the conditions of section 631(b) are otherwise met, advance and minimum payments are treated as realized from the sale of timber, if the timber for which the payments apply is cut more than six months after the date of acquisition. If the buyer can not perform under the contract and forfeits some portion of the advance or minimum payments, the amount not applied to actual units cut is ordinary income to the seller. Amended returns must be filed when necessary.

Election for Alternate Disposal Date

When payment is received before the timber is cut the owner may elect to treat the payment date as the disposal date. The election is made by attaching a statement to a timely filed return (including extensions) for the period in which the payment is received identifying the payment and the contract.

If the payment date would provide more than a six month holding period there would be no purpose for the election since the cutting date would also provide more than six months and nothing would be changed by the election. However, if the payment date would not provide more than a six month holding period then the election would take that payment out from under the provisions of section 631(b).

When the payment represents a gain, the gain could be used to offset other types of losses that would otherwise expire. If a loss, the loss could be used to offset or reduce other types of income. It should not be presumed that the election will convert the gains and losses into ordinary gains or losses since the disposal dates and provisions of section 631(b) do not apply. Careful consideration should be given to the terms of the contract, provisions of local law and the business of the seller.

Basis of Timber

As in subsection (a), the taxpayer determines basis or depletion rate on a per unit basis. In the case of advances or minimum payments, basis is allowed in accordance with the number of units paid for by the prepayments. If a bonus is paid under the contract, the basis for the bonus proceeds is determined by applying a fraction to the total basis of the timber to be cut; the numerator of which is the amount of the bonus and the denominator is the total expected proceeds under the contract including the bonus. If part of the timber is cut prior to the required six months holding period, the bonus must be pro-rated to this period based on footage.

As the disposal date is now deemed to be the cutting date, it would appear to be possible to see timber not in existence at the contract date and satisfy the requirements of section 631(b). However, the Internal Revenue Service has recently ruled that the proceeds would be ordinary income and a final determination must await litigation. It would be necessary to satisfy local laws as to what constitutes a sale and still avoid a royalty classification.

Time for Reporting

Neither the payment date election of disposal nor other provisions of section 631(b) have any effect on the time for reporting gain or loss.

Gain or loss is reported when payment is received or accrued unless the terms of the contract and the provisions of local law clearly make the consideration other than royalty or lease payments.

The Future of Section 631

In June 1963, while considering the President's 1963 tax message, the House Ways and Means Committee killed the administration's plea for a sharp cutback in the capital gains allowance on timber. In reporting the Committee's action, Representative Al Ullman (D-Ore.) said: "Treasury admitted its position was not sound after the Forest Service said its proposal would seriously affect reforestation."

READING REFERENCES

Section 631 and regulation 1.631 — Gain or loss in the case of timber or coal.

Section 611 and regulation 1.611-3 — Allowance for deduction for depletion.

Regulation 1.611-3(f) — Determination of fair market value of timber property.

Section 1221 and regulation 1.1221 — Capital asset defined.

Section 1231 and regulation 1.1231 — Property used in the trade or business and involuntary conversions.

NYU 18 — Institute on Federal Taxation (p.577) Tax Aspects of Timber Transactions by Thomas V. Lefevre.

L. D. Wilson (26 TC 474) — Retained economic interest.

Ah Pah Redwood Co. — (251 F. 2d 163) — Holding period and capital assets status.

Revenue Ruling 56-434 — Fair market value of timber and application of section 631 to tops and limbs.

Revenue Ruling 57-90 — Application of section 631(b) regardless of taxpayer's business of purpose or which the timber is held.

Revenue Rulings 62-81 and 62-82 — Sale and lease distinguished, timber not in existence and retained economic interest.

President's 1963 Tax Message (House Ways and Means Committee Print) Page 382 — Tax treatment of timber.